

applied. (The corporation may make a new election under § 1.936-1 (a) for any subsequent taxable year.) The corporation shall make this revocation by sending to the Philadelphia Center a written statement of revocation on or before April 8, 1980.

(Secs. 7805 and 936(e) of the Internal Revenue Code of 1954 (68A Stat. 917 and 90 Stat. 1644; 26 U.S.C. 7805 and 936(e)))

[T.D. 7673, 45 FR 8588, Feb. 8, 1980; T.D. 7673, 45 FR 16174, Mar. 13, 1980]

§ 1.936-4 Intangible property income in the absence of an election out.

The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e), where applicable.

Q. 1: If a possessions corporation and its affiliates do not make an election under either the cost sharing or 50/50 profit split option, what rules will govern the treatment of income attributable to intangible property owned or leased by the possessions corporation?

A. 1: Intangible property income will be allocated to the possessions corporation's U.S. shareholders with the proration of income based on shareholdings. If a shareholder of the possessions corporation is a foreign person or a tax-exempt person, the possessions corporation will be taxable on that shareholder's pro rata amount of the intangible property income. If any class of the stock of a possessions corporation is regularly traded on an established securities market, then the intangible property income will be taxable to the possessions corporation rather than the corporation's U.S. shareholders. For these purposes, a United States shareholder includes any shareholder who is a United States person as described under section 7701(a)(30). The term "intangible property income" means the gross income of a possessions corporation attributable to any intangible property other than intangible property which has been licensed to such corporation since prior to 1948 and which was in use by such corporation on September 3, 1982.

Q. 2: What is the source of the intangible property income described in question 1?

A. 2: The intangible property income is U.S. source, whether taxed to U.S.

shareholders or taxed to the possessions corporation. Such intangible property income, if treated as income of the possessions corporation, does not enter into the calculation of the 80-percent possessions source test or the 65-percent active trade or business test of section 936(a)(2)(A) and (B).

Q. 3: How will the amount of income attributable to intangible property be measured?

A. 3: Income attributable to intangible property includes the amount received by a possessions corporation from the sale, exchange, or other disposition of any product or from the rendering of a service which is in excess of the reasonable costs it incurs in manufacturing the product or rendering the service (other than costs incurred in connection with intangibles) plus a reasonable profit margin. A reasonable profit margin shall be computed with respect to direct and indirect costs other than (i) costs incurred in connection with intangibles, (ii) interest expense, and (iii) the cost of materials which are subject to processing or which are components in a product manufactured by the possessions corporation. Notwithstanding the above, certain taxpayers who have been permitted by the Internal Revenue Service in taxable years beginning before January 1, 1983, to use the cost-plus method of pricing without reflecting a return from intangibles, but including the cost of materials in the cost base, will not be precluded from doing so. (Sec. 3.02(3), Rev. Proc. 63-10, 1963-1 C.B. 490.) Thus, the Internal Revenue Service may continue in appropriate cases to permit such taxpayers to continue to report their income as they have been under existing procedures described in the previous sentence if it is appropriate under all the facts and circumstances and does not distort the income of the taxpayer.

Q. 4: If there is no intangible property related to a product produced in whole or in part by a possessions corporation, what method may the possessions corporation use to compute its income?

A. 4: The taxpayer may compute its income using the appropriate method as provided under section 482 and the regulations thereunder. The taxpayer

may also elect the cost sharing or profit split method.

[T.D. 8090, 51 FR 21524, June 13, 1986]

§ 1.936-5 Intangible property income when an election out is made: Product, business presence, and contract manufacturing.

The rules in this section apply for purposes of section 936(h) and also for purposes of section 934(e), where applicable.

(a) Definition of product.

Q. 1: What does the term “product” mean?

A. 1: The term “product” means an item of property which is the result of a production process. The term “product” includes component products, integrated products, and end-product forms. A component product is a product which is subject to further processing before sale to an unrelated party. A component product may be produced from other items of property, and if it is so produced, may be treated as including or not including (at the choice of the possessions corporation) one or more of such other items of property for all purposes of section 936(h)(5). An integrated product is a product which is not subject to any further processing before sale to an unrelated party and which includes all component products from which it is produced. An end-product form is a product which—

(1) Is not subject to any further processing before sale to an unrelated party;

(2) Is produced from a component product or products; and

(3) Is treated as not including certain component products for all purposes of section 936(h)(5).

A possessions corporation may treat a component product, integrated product, or end-product form as its possession product even though the final stage or stages of production occur outside the possession. Further processing includes transformation, incorporation, assembly, or packaging.

Q. 2: If a possessions corporation produces both a component product and an integrated product (which by definition includes the end-product form), may the possessions corporation use the options under section 936(h)(5) to com-

pute its income with respect to either the component product, the integrated product or the end-product form?

A. 2: Yes. The possessions corporation may choose to treat the component product, the integrated product, or the end-product form as the product for purposes of determining whether the possessions corporation satisfies the significant business presence test. The possessions corporation must treat the same item of property as its product (the possession product) for all purposes of section 936(h)(5) for that taxable year, including the significant business presence test under section 936(h)(5)(B)(ii), the possessions sales calculation under section 936(h)(5)(C)(i)(I), the determination of income under section 936(h)(5)(C)(i)(II), and the combined taxable income computations under section 936(h)(5)(C)(ii). Although the possessions corporation must treat the same item of property as its product for all purposes of section 936(h)(5) in a particular taxable year, its choice of the component product, integrated product or end-product form may be different from year to year. The possessions corporation must specify the possession product on a statement attached to its return (Schedule P of Form 5735). The possessions corporation may specify its choice by either listing the components that are included in the possession product or the components that are excluded from the possession product. The possessions corporation must file a separate Schedule P with respect to each possession product. The possessions corporation must attach to each Schedule P detailed computations indicating how the significant business presence test is satisfied with respect to the possession product identified in that Schedule P.

Q. 3: A possessions corporation produces a product that is sometimes sold to unrelated parties without further processing and is sometimes sold to unrelated parties after further processing. May the possessions corporation choose to treat the same item of property as the possession product even though in some cases it is an integrated product and in some cases it is a component product?